No. 11492

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

P. G. WINNETT,

Appellee.

Upon Appeal from the District Court of the United States for the Southern District of California, Central Division

---

BRIEF OF APPELLEE.

MACFARLANE, SCHAEFFER & HAUN,
417 South Hill Street, Los Angeles 13,

DEMPSEY, THAYER, DEIBERT & KUMLER,
523 West Sixth Street, Los Angeles 14,

Attorneys for Appellee.

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Statutes

Textbooks

INDEX TO APPENDIX

No. 11492

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

P. G. WINNETT,

Appellee.

BRIEF OF APPELLEE.

Statement.

The statement as prepared by appellant's counsel is acceptable with the exception of that portion on page 8 reading as follows:

> "The court made no specific finding or conclusion as to whether the taxpayer had or had not committed an act or acts of bankruptcy though the parties and the court treated the elements embraced in the provisions of Section 3466 of the Revised Statutes as issues raised in the case [R. 81, 85, 88, 89, 95, 96, 101, 129].
>
> "Emma A. Summers had committed acts of bankruptcy before and after the basic dates as will be hereinafter shown in the argument."

We disagree with the statement that the parties and the court treated the elements embraced in the provisions of Section 3466 of the Revised Statutes as issues raised

in the case or that any issue was made as to whether Emma A. Summers had committed acts of bankruptcy. The references by counsel to the record do not support the statement, but, in fact, support the contrary, *i. e.*, that counsel for defendants objected to such issue, to the filing of an amended complaint to include such issue, and the court sustained these objections and refused to permit the filing of such proffered amended complaint [R. 95, 96, 101-104, 105, 106].

Summary of Argument.

On and after January 1, 1939, Emma A. Summers, a creditor of P. G. Winnett, was an insolvent person, and P. G. Winnett was entitled to off-set against his indebtedness to Summers all claims which he held against her, whether matured or unmatured, and to have determined the net balance remaining and was liable to Summers or her successors in interest only for this net balance. The appellant's lien for taxes filed February 16, 1939, and the purported levy and demand made March 22, 1939, could rise no higher than Summers' rights against Winnett and attached only to the property or rights to property that Summers had, and such property or rights to property are determined by the laws of the State of California, and through the application of such law appellant is limited, as Summers would have been limited, to the sum of $6,466.64, plus interest, and neither the lien of appellant, its purported levy and demand, nor the provisions of Section 3466 of the Revised Statutes, operated to deprive Winnett of the set-offs alleged and proved. We will first discuss the argument of counsel for plaintiff and follow this with our argument, points and authorities.

ARGUMENT.

I.

In Answer to Appellant's Point I:

Counsel for appellant make an erroneous application of Section 3710 (a) and (b) to the instant case and overlook the essential elements thereof. There was no distraint upon P. G. Winnett on March 22, 1939, or at any other time. Under Section 3710 a levy is a prerequisite, and a mere notice does not constitute a levy [Exs. 4, 5]. *United States v. Aetna Life Insurance Co.*, 46 F. Supp. 30, 29 A. F. T. R. 1123, 1130; *United States v. O'Dell* (C. C. A. 6), 160 F. (2d) 304. In this latter case a notice and demand similar to that in the instant case was given. The court held this did not amount to a levy and stated:

> "This paragraph described a mere statement or notice of claim. Nothing alleged to have been done amounted to a levy which requires that the property be brought into legal custody through seizure, actual or constructive, levy being 'an absolute appropriation in law of the property levied upon' (citing cases)."

Nothing, therefore, was accomplished by the notice of March 22, 1939, and P. G. Winnett's rights were, therefore, not affected by that notice. Even if the levy was effectual it gave the appellant no rights beyond those of Emma A. Summers (Point IV, *infra*).

II.

In Answer to Appellant's Point II:

As pointed out in answer to Point I, no rights of appellant arose on March 22, 1939. It is conceded that the appellant had a lien on February 16, 1939, but it is contended that this lien affected only the property and rights to property of Summers, an insolvent person on that date [R. 115]. The determination of what constituted her property is a matter of State law. *U. S. v. Malcolm,* 282 U. S. 792, 75 L. Ed. 714; *U. S. v. Roberts,* 269 U. S. 315, 70 L. Ed. 285; *Warburton v. White,* 176 U. S. 484, 44 L. Ed. 555; *Hines v. Martin,* 268 U. S. 458, 69 L. Ed. 1050; *Burgess v. Seligman,* 107 U. S. 123, 27 L. Ed. 359; *Lippencott v. Mitchell,* 94 U. S. 766, 24 L. Ed. 315; *United States v. Penn Mutual Life* (D. C., E. D., Pa.), 44 F. Supp. 804, 29 A. F. T. R. 405, where on page 407 the court states:

> "This court is bound by the law of Pennsylvania as to what constitutes property."

As will be more fully pointed out later (Point IV, *infra*) the laws of California when applied in this case fixed the property and rights to property of Summers at $6,466.64, plus interest. It may be, as stated by counsel for appellant, that State laws are ineffectual to supersede, impair or modify the statutory rights of the United States as to the priority of its liens and claims, but such decisions are not helpful since we are first concerned with the property or rights to property to which this lien attached. Counsel in discussing set-off cites some early California cases with the statement that they had not been overruled

or expressly modified. That may be, but these cases arose prior to 1927 when Sections 437 and 438 of the Code of Civil Procedure [Appendix, *infra*] were amended and which code sections now govern the right of set-off and counter-claim, and the decisions clearly establish Winnett's right to set off his demands as we will show (Point IV, *infra*).

Appellant contends (Appellant's Brief 20) that there was no mutuality between the off-sets of Winnett and those of the taxpayer, citing authorities which, however, do not support its statements. Mutuality has been defined, "The doctrine of mutuality requires that the debts be to and from the same persons in the same capacity." *Peterson v. Lyders,* 139 Cal. App. 303, 306, 33 P. (2d) 1030; certiorari denied, 294 U. S. 716.

Winnett had a contractual relation with Summers [R. 185, Ex. E, F] and by which Summers' obligations to him arising out of his endorsement of her notes at the Bank were directly deductible from his obligation to her evidenced by the $60,000.00 promissory note [Ex. C]. Certainly the debts were due to and from the same persons in the same individual capacities. The action of the Appellant could not disturb this original mutuality. Furthermore, when Winnett satisfied his guaranty and endorsement to the Bank, a further direct obligation from Summers arose in his favor as a matter of law.

Since 1927 the law is well settled that the off-sets or credits need not arise out of the same transaction. Cal. Civ. Code 438 (Point IV, *infra*).

Winnett's rights of set-off were not obtained after February 16, 1939, but were in existence as early as sometime after December 20, 1935 [R. 194, 250], and the $60,000.00 promissory note contained an endorsement, "May 26, 1938. This note subject to an agreemet set forth in my letter to Mr. P. G. Winnett dated May 26, 1938 (signed) J. M. Woods.", giving notice of his rights [Ex. 12, C., R. 224, 225]. Also [Ex. E, F]. Even though the obligations were not paid until May 17, 1939, the right of set-off existed immediately upon the insolvency of Summers (January 1, 1939). The Government's lien attached only to Summers' property (her interest in the note which of itself gave notice of Winnett's rights) and was subject to her agreement with Winnett and to Winnett's rights arising by reason of such insolvency. Counsel state that Winnett purchased the Summers' notes from the Bank, but this is contrary to the evidence. Winnett's payment to the Bank was in satisfaction of his liability to it as an endorser of these notes [R. 90, 252, 253, 254, 258, 471]. The liability of an endorser is direct and primary (Sec. 3144, Cal. Civ. Code, Appendix, *infra*). As an endorser paying the obligation he immediately became entitled to recover from the maker (Sec. 3202, Cal. Civ. Code, Appendix, *infra*). This right flowed as a result of the endorsement and was in addition to the direct written agreements from Summers. The Bank could demand payment of the entire sum of principal and interest by reason of default by Summers in the payment of interest, which it did on May 17, 1939. *Righetti v. Monroe,* 109 Cal. App. 333 at page 336.

Winnett also had the right to off-set the $2400.00 installment note under the agreement of December, 1938, which was then in default [R. 122]. The cases cited by counsel have been reviewed, and we believe that they do not affect our position. *Glass City Bank v. United States* holds only that the lien attaches to property owned by the taxpayer. *In re Lambertson Rubber Co.* held that the taxes were liens of a character which would become simple priorities under the Bankruptcy Act. *Citizens State Bank of Barstow* held that the tax lien covered the property and rights to property as of the date upon which the assessment list was received in the Collector's office. *MacKenzie v. United States* held that the tax lien took precedence over a writ of attachment subsequently levied. *United States v. Greenville* held that the tax lien took precedence over state and municipal liens which had not yet been perfected. While Winnett is not among the classes excepted in Section 3672, this is immaterial since he can always show that there was no property or property rights of the taxpayer in his possession, and did show that such rights were limited to the sum of $6,466.64, and interest. The additional cases of *U. S. v. Oklahoma, U. S. v. Wadell, New York v. McClay* and *People of Illinois v. Campbell*, cited by counsel, do not aid appellant, since these decisions govern priority of the U. S. over unperfected liens and do not go into the question of the property itself which became the subject of the lien.

III.

In Answer to Appellant's Point III:

Section 3466, Revised Statutes, creates no lien but establishes a priority. *United States v. Wadell,* 323 U. S. 353, 89 L. Ed. 294. And if applicable at all applied only to the balance due from P. G. Winnett to Summers after giving effect to the credits and off-sets. *U. S. v. Geiger,* D. C. Ark., 26 F. Supp. 624, where it is stated:

> "This section does not create a lien but merely gives priority to claims of U. S. after legal title has passed from debtor."

The priority does not attach until the debtor has been devested of his property in one of the modes stated herein, in which case the person who is vested with the title becomes trustee for the United States and is bound to pay its claim first out of the property. *In re Baltimore Pearl Hominy Company,* D. C., Md. 1923, 294 Fed. 921. Reversed on other grounds, C. C. A. at 925, 5 F. (2d) 553. *In re C. J. Rowe & Bros.,* D. C., Pa. 1927, 18 F. (2d) 658.

In *Bramwell v. United States Fidelity & G. Co.,* 269 U. S. 483, 70 L. Ed. 368, the court in speaking of Sections 3466 and 3467 states:

> "Taken together these sections mean that a debt due the United States is required first to be satisfied when the possession and control of the estate of the insolvent is given to any person charged with the duty of applying it to the payment of the debts of the insolvent as the rights and priorities of creditors may be made to appear."

Winnett is not a person charged with the duty of liquidating Summers' financial condition.

That the right of set-off is recognized as to insolvent creditors is sustained by the following authorities:

Schuler v. Israel and the Laclede Bank, 120 U. S. 506, 30 L. Ed. 707;

Carr v. Hamilton, 129 U. S. 252, 32 L. Ed. 669;

Scott v. Armstrong, 146 U. S. 510, 36 L. Ed. 1059;

Armstrong v. Warner, 49 Ohio S. T. 376, 17 L. R. A. 466;

Jandrew v. Guaranty State Bank, 294 Fed. 530;

Studley v. Boylston National Bank, 229 U. S. 523, 57 L. Ed. 1313;

New York County National Bank v. Massey, 192 U. S. 138, 48 L. Ed. 380;

Fidelity and Deposit Company of Maryland v. Duke, 293 Fed. Rep. 661, which states at page 665:

"And in any such set-off is no preference, for only the excess is justly owing or assets to whom due, insolvent or not." (Citing *Scott v. Armstrong, supra.*)

The foregoing support the general statements contained in 28 American Jurisprudence 792:

"The allowance as a set-off of a claim acquired prior to the insolvency proceedings is based upon the idea that where the right of set-off exists at such time, the debtor equitably owes only the balance over and above the amount which the insolvent owes him, and this is the debt that passes to the trustee in insolvency, assignee for creditors or receiver, and hence that the allowance of the set-off does not amount to a preference."

With respect to the argumentative matter under Point III, it is the Appellee's contention that no act of bankruptcy was committed by the taxpayer on December 20, 1935, in connection with the debt evidenced by the $60,000.00 note here under consideration. It must be borne in mind that when the Appellant's taxes accrued for 1927 Summers was a woman of wealth, having assets of at least $609,000.00 [R. 182] consisting of $275,000.00 cash and promissory notes of one John G. Bullock and defendant P. G. Winnett aggregating $333,000.00 [R. 182]. She may have been worth $1,000,000.00 [R. 509]. During the time from 1927 to December 20, 1935, said Bullock and the defendant Winnett had paid her in cash on account of said notes at least $313,000.00 [R. 182]. On December 20 1935, she was known to have at least $60,000.00, *i. e.*, the balance due from Winnett of $20,000.00 and $40,000.00 cash, and nowhere does the evidence show that she had disposed of the approximately $550,000.00 received by her from 1927 to that date. Winnett's transactions with her were in the ordinary course of business and not dissimilar to those that had existed for approximately 8 years [R. 182]. She appeared to be a woman of peculiar business characteristics, and during the course of years had carried notes in the names of other persons and with whose interest therein Winnett was unfamiliar [R. 186]. Winnett, therefore, had no reason to consider the transaction of December 20, 1935, as being any different than her usual conduct of business. She informed him that Woods was her brother [R. 184]. Summers, whether acting in her own name or in the name of Woods, continued to hold the $60,000.00 note and to have it in her possession until at least October 24, 1941 [R. 232]. This transaction constituted no concealment of her assets since the note represented a portion of her assets. It was amply

secured, and Winnett stated that he could have paid it in cash at any time [R. 186]. The fact that Winnett was President of Bullock's nor his testimony concerning the transaction does not disclose any intent on his part to aid her in concealing her assets. We think the following quoted testimony explains his action [R. 183]:

> "But she told me she felt I was under an obligation, that she didn't expect Mr. Bullock to die and she would be deprived of that six per cent on that note, and she thought I should take care of it. And she was either a good salesman, or I was a little soft-headed, but I had—I was the one who suggested that this time it be a secured note, and that stock was put up with S. F. McFarlane, as a trustee. I felt in case of my death her note should be properly protected, and it looked like a better business arrangement anyway. These transactions with Emma Summers extended over a period of 14 years. She was 69 years of age when we started our negotiations originally, and there were very few months in that 14 years that I didn't see her personally."

Counsel stress the oral agreement on the part of Woods (Summers) by which amounts paid by Winnett would be credited on the $60,000.00 note (Appellant's Br. 23). Since Summers was acting under a power of attorney as attorney-in-fact for Woods she could make binding commitments on his behalf [Ex. D]. Nor do we find anything significant in the fact that Winnett, a business man as Appellant points out, should obtain a written agreement and destroy the negotiability of the $60,000.00 note when he heard the taxpayer was in difficulties or otherwise. If Woods were a real person, how can Appellant assume that the agreement on the part of Summers would be a breach of trust and invalid as to Woods? It is quite possible

that she could have had business dealings with Woods which permitted this. This argument, however, is purely speculative since it has been found that Woods and Summers were one and the same person. Appellant's statement on page 24 that the transfer of the $60,000.00 consideration for the original note was done by the taxpayer with intent to hinder, delay or defraud her creditors and that Winnett actively participated in such intent and accomplishment with knowledge is wholly without support in the evidence and is contrary to the findings of the trial judge who had the opportunity to observe this witness and to conclude as to his credibility and good faith.

Appellant's statement of the law respecting presumption (Appellant's Br. 24) is erroneous. The law is (Cal. C. C. P. 1963) "That a thing once proved to exist continues so long as is usual with things of that nature." A condition of insolvency on a particular date does not cause a presumption that it existed before that date. The law appears to be that no inference arises from an adjudication of bankruptcy that the bankrupt was insolvent within the meaning of the Act four months before he was adjudicated such. *Liberty National Bank v. Bear,* 265 U. S. 365, 68 L. Ed. 1057; Anno. 11, Ann. Cas. 452, and quoting from the Anno. 11, Ann. Cas. 452:

> "Proof that a man was insolvent on a certain day does not justify an inference that he was insolvent on a day sometime prior thereto. Many contingencies such as unwise investments, losing contracts, misfortune or accident might happen to reduce a person from a state of solvency to one of insolvency within a short space of time."

The trial court determined from the evidence that the insolvency of Summers was from January 1, 1939.

The execution of the written agreements in favor of Winnett on May 26, 1938, and August 26, 1938 [R. 121, 221, 222] does not constitute a preference since so far as the record discloses they were made in the ordinary course of business, and there is no finding of insolvency at the time.

But even if such written instruments constituted a preference they were not void but would have been voidable had bankruptcy ensued within four months after it was made. 11 U. S. C. A. Sec. 96; Remington on Bankruptcy (5th Ed.), Vol. 4A, Sections 1657, 1693. It is not unlawful for an insolvent debtor to prefer a creditor. *Van Iderstine v. National Discount Co.,* 227 U. S. 575, 582, 57 L. Ed. 652; *Riedell v. Lydick,* 176 Okla. 204, 55 P. (2d) 465, 466.

Whether an act of bankruptcy was committed when the Appellant obtained its lien on February 16, 1939, or when Appellant obtained its judgment on August 5, 1946, would be immaterial to the determination of this case (Point IV, *infra*). In fact, one of the cases cited by Appellant, that of *Bramwell v. U. S. Fidelity Company,* 269 U. S. 483, contains this very significant quoted language (Appellant's Br. 27, 28):

> "The Act applies to all debts due from deceased debtors whenever their estates are insufficient to pay all creditors, and extends to all debts due from insolvent living debtors when their insolvency is shown

in any of the ways stated in Sec. 3466. The decisions of this court show that no lien is created by the statute; that priority does not attach while the debtor continues the owner and in possession of the property; that no evidence can be received of the insolvency of the debtor until he has been devested of his property in one of the modes stated; and that, 'whenever he is thus devested of his property, the person who becomes invested with the title, is thereby made a trustee for the United States, and is bound to pay their debt first out of the proceeds of the debtor's property.' *Beatson v. Farmers' Bank, supra,* 133, and cases cited; *United States v. Oklahoma,* 261 U. S. 253, 259."

And this court in its decision in *U. S. v. Sampsell,* 153 F. (2d) 731, apparently quotes with approval from the case of *In re Van Winkle,* 49 Fed. Supp. 711, D. C. Ky. 1943, in discussing Section 3466:

"The court held that an equitable lien of surety, upon payment of the claim against the bankrupt by the surety, may be related back to the date of the contract and assignment of the retained percentage to defeat the Government's lien which arose prior to the date of actual payment, but was not prior to the date of the contract and assignment. . . . The trustee acquires no better title than the bankrupt himself had."

Appellant's statement (Appellant's Br. 29) that P. G. Winnett was a trustee for the United States is an erroneous assumption and is not borne out by the authorities cited nor by the findings of the court below. The record

discloses only the relationship of debtor and creditor existing between Winnett and the taxpayer.

But admitting for the purpose of argument only that Summers committed acts of bankruptcy as early as 1935 and was an insolvent person, since Section 3466 gives rise to no lien, such insolvency operated to give Winnett the benefit of the State law with respect to his credits and off-sets and gave Appellant priority as to the balance when Summers was devested of said balance. This is the debt that passes to the trustee in insolvency, assignee for creditors, or receivers, and upon such devestment the Appellant acquires priority. As we pointed out under our Point II the determination of what constituted the property of Summers is a matter of State law. *United States v. Malcolm, supra; United States v. Roberts, supra; Warburton v. White, supra; Hines v. Martin, supra; Burgess v. Seligman, supra; Lippencott v. Mitchell, supra; United States v. Penn. Mutual Life,* and the right of set-off and counterclaim is likewise a matter of State law. *Dushane v. Benedict,* 120 U. S. 630, 7 S. Ct. 696, 30 L. Ed. 810; *Woodland Farm Dairy Co. v. Dairy R. Co.,* 282 Fed. 278.

IV.

The Only Property or Rights to Property Had by Summers and Here Involved, Was the Unpaid Balance of the Winnett Note After Deducting the Credits and Off-Sets. Such Rights of Set-Off and Credits Could Be Asserted Against Appellant Regardless of Its Lien, Its Purported Distraint and Section 3466 Revised Statutes.

A. The Only Property or Rights to Property Had by Summers and Here Involved, Was the Unpaid Balance of the Winnett Note After Deducting the Credits and Off-Sets.

On December 20, 1935, Winnett was indebted to Summers in the sum of $20,000.00 as the balance due on an original promissory note executed by one John G. Bullock and Winnett in the sum $333,000.00. On that date he borrowed an additional $40,000.00, gave a new note for the combined sum of $60,000.00 and secured it by collateral consisting of 1800 shares of the capital stock of Bullock's, Inc. Thereafter Winnett had an oral agreement with Summers (acting in the name of Woods) that her said promissory notes which he might endorse at the Citizens Bank, if unpaid, could be deducted from the $60,000.00 note [R. 182, 183, 184, 185]. This agreement was thereafter evidenced by two writings [Ex. B, F] and further claimed off-sets were evidenced by writings [Ex. G, H and O]. Summers was insolvent on and after January 1, 1939 [R. 115]. Appellant asserted a tax lien February 16, 1939, upon property or rights to property of Summers. On March 22, 1939, appellant gave a notice of purported levy to Winnett which was ineffectual for any purpose (Point II, *supra*). May 17, 1939, the Citizens Bank called the Summers notes for payment and made demand upon Summers and Winnett as the endorser [Ex. I]. Pursuant

to this demand Winnett paid the notes. The Bank endorsed and delivered the notes to him so that he could proceed against the maker. This was not a sale of the notes and Winnett was not purchasing them as stated by appellant, but he made payment in extinguishment of his indebtedness and guarantee [R. 94, 95, 123, 124]. Winnett's right of set-off and counterclaim is statutory and is governed by Sections 437 and 438, California Code of Civil Procedure [Appendix *infra*]. Under the decisions since the adoption of said code sections in 1927, the right of set-off and counterclaim may be asserted in the action instituted by appellant. *Bond v. Farmers and Merchants National Bank,* 64 Cal. App. (2d) 842, at page 845:

> "There is nothing contained in this section to indicate that the Legislature intended that the counterclaim must have existed at the time of the commencement of the action. The existing statute was the evident attempt on the part of the lawmakers to establish a new law for the regulation of the pleading of counterclaims. Inasmuch as it is a complete statute in itself without reference to the superseded section, a reasonable interpretation is that the Legislature undertook to formulate a plan complete in itself without reference to the original provision upon that subject. It appearing that the Legislature's intention was to revise the entire subject matter of section 438 it must be presumed that they intended to substitute a new law for that which had formerly existed, and that any content of the old statute not repeated should be considered as repealed by the new even though there be no inconsistencies between the two. (*Mack v. Jastro,* 126 Cal. 130, 132 (58 Pac. 372); *Stockburger v. Jordan,* 10 Cal. (2d) 636, 646 (76 P. (2d) 671); *Jewett v. City Transfer & Storage Co.,* 128 Cal. App. 556, 561 (18 Pac. 2d 351). The enactment of the new

statute will not be considered as repealing by implication but rather it is to be understood that the later legislative attempt is a revision of the entire subject matter embodied in the successive legislative enactments and that the latest was designed as a substitute for all preceding acts. Whatever of the old is excluded from the new must be ignored. All the limitations upon the right to counterclaim not found in section 438 as amended must be deemed to have been abolished by the new section. (*Buckman v. Tucker,* 9 Cal. (2d) 403, 408 (71 P. (2d) 69); *Todhunter v. Smith,* 219 Cal. 690, 603 (28 P. (2d) 916; *Terry Trading Corp. v. Barsky,* 210 Cal. 428, 435 (292 Pac. 474).)"

Even without the question of insolvency, the set-off was properly due at the time of suit. *Cohen v. Bonnell,* 14 C. A. (2d) 38; *St. Louis National Bank v. Gay,* 101 Cal. 286, at page 292.

Where the question of insolvency arises the right of set-off immediately arises whether the alleged set-off is based upon a contingent obligation, an immature obligation, or a conditional obligation, and this proceeds upon the theory that insolvency renders all debts due and furnishes of itself a sufficient ground for set-off. These propositions of law are sustained by the case of *Harrison v. Adams,* 20 Cal. (2d) 646 (one of the latest expressions), and we quote from this decision beginning on page 648:

"Concerning the rights of the appellant to the money on deposit as against the assignee of the judgment for a valuable consideration, *it is well settled that a court of equity will compel a set-off when mutual demands are held under such circumstances that*

one of them should be applied against the other and only the balance recovered. The insolvency of the party against whom the relief is sought affords sufficient ground for invoking this equitable principle. (Citing cases.) (Emphasis ours.)

And a judgment debtor who has, by assignment or otherwise, become the owner of a judgment or claim against his judgment creditor, may go into the court in which the judgment against him was rendered and have his judgment off-set against the first judgment. (Citing cases.) The fact that the demand of the plaintiff has not been reduced to judgment is no obstacle to its allowance as a set-off against a judgment. (Citing cases.) Such a set-off may be compelled even against an assignee of the judgment who took without notice and for value. (Citing cases.)

It has also been held that under section 368 (Appendix *infra*) of the Code of Civil Procedure the debtor may set off claims against the creditor which were acquired after the assignment of the judgment to a third person but prior to notice to the debtor of the assignment. (Citing cases.) 'Whatever may be the rule as to notice in other states, however much or little the courts may have permitted themselves to be influenced by equitable considerations in favor of the assignee, the fact remains that in this state there is no room for the exercise of discretion upon this question. The rule is one rigidly fixed by statute . . .' (Citing cases.)

But the assignee must be the beneficial owner of the claim or judgment in order to use it as a set-off against a judgment against him. (Citing cases.) And mutuality is essential, that is, the judgments must be between the same parties in the same right. (Citing cases.) In determining whether demands are mutual, *equity will look to the real parties in interest.* Thus

there may be a set-off of judgments where the real and beneficial owner of one of them is the debtor upon the other, although an assignee for collection is the nominal owner of the first judgment. (Citing cases.)" (Emphasis ours.)

Another decision sustaining this is *Gordan v. Foote,* 120 Cal. App. 76. This was an action by a receiver of an insolvent lessor to recover unpaid rents from the lessee. The question was whether defendant was entitled to off-set $15,000.00 paid to the lessor as security for the rent under the lease due to the fact that the deposit was not returnable until the thirty-first month and then only at the rate of $357.00 per month and upon condition that defendant execute a chattel mortgage on the furnishings. The court stated on page 79:

> "The propriety of allowing the off-set is at once apparent and in view of the fact that the lessor had become insolvent it is immaterial that under the terms of the lease the return of the deposit was not yet due. In *City Investment Co. v. Pringle,* 73 Cal. App. 782 (239 Pac. 302), the court reviewed the authorities relating to setoffs against insolvent debtors and there said at page 791, ' . . . *insolvency itself is a sufficient ground for the application of equitable setoff, and the fact that the indebtedness on one side is not due when setoff is claimed constitutes no obstacle to the assertion of the right as against an insolvent debtor.*' " (Emphasis ours.)

The case of *City Investment Co. v. Pringle,* 73 Cal. App. 782, cited in the foregoing case was an action where the plaintiff sued for rents, and the defendant set up a

counterclaim for a deposit, and the facts showed that the plaintiff was insolvent. The court on page 791 stated:

> "The majority of the cases wherein the rule has been applied have been those in which a bank has sought to set off the unmatured indebtedness of an insolvent depositor to it as against a claim for the deposit by the depositor or his representative or as against the assignee of such depositor. The principle, however, applies in all cases where a right of the insolvent is asserted, and in accordance with equitable principles set-off should be permitted. As held in *Nashville Trust Co. v. Fourth Nat. Bank, supra,* cited with approval in the cases of *Pendleton v. Hellman Com. etc. Bank, supra,* and *Coonan v. Loewenthal, supra,* insolvency itself is a sufficient ground for the application of equitable set-off, and *the fact that the indebtedness on one side is not due when set-off is claimed* constitutes no obstacle to the assertion of the right as against an insolvent debtor." (Emphasis ours.)

In *Machado v. Borges,* 170 Cal. 501, the court with respect to this equitable right of set-off stated at page 502:

> "It is well settled that a court of equity will compel a set-off of mutual demands, where such relief is necessary to enable the party claiming the relief to collect his claim. (*Russell v. Conway,* 11 Cal. 93; *Hobbs v. Duff,* 23 Cal. 596.)
>
> The insolvency of the party against whom the relief is sought affords sufficient ground for invoking this equitable remedy. (*Hobbs v. Duff,* 23 Cal. 626, 627.)"

Again in *People v. California etc. Trust Company,* 168 Cal. 241, a question arose as to the right of set-off against the receiver of an insolvent bank. At page 246 the court stated:

> " 'The general rule is that a receiver acquires no greater interest in an estate than the one from whom he takes, and it follows that choses in action pass to him subject to any right of setoff existing at the time of his appointment.' (Pomeroy's Equitable Remedies, Vol. 1, Secs. 186, 187.) This rule applies in the case of insolvent banks, so that the right of setoff is to be determined by the condition of things as they existed at the moment the bank became insolvent."

At page 250 the court stated:

> "The creditor may be insolvent, and it is well settled that the insolvency of a party against whom a setoff is claimed constitutes a sufficient ground for the allowance of a setoff not otherwise available."

And in *Arp v. Blake,* 63 Cal. App. 362, the court on this same question, at page 367 stated:

> "The right of set-off exists when the parties hold cross-demands under such circumstances that in equity they should be applied one against the other and only the balance be recovered." (Citing cases.)

In addition to the legal rights established by the foregoing decisions, there was an absolute agreement on the part of Summers authorizing and permitting the right of set-off which established a far greater mutuality than the cases cited.

B. Such Rights of Set-Off and Credits could be Asserted Against Appellant Regardless of Its Lien, Its Purported Distraint and Section 3466 Revised Statutes.

The appellant by its lien or by its purported distraint proceedings acquired rights no higher than those of Summers and, in fact, held the position of a garnishee. *United States v. Bank of United States,* 5 Fed. Supp. 942, the court stating:

> "It is settled law, as shown by the case of *North Chicago Rolling-Mill Co. v. Ore & Steel Co.,* 152 U. S. 596, 14 S. Ct. 710, 38 L. Ed. 565, that when one seeks to reach a chose in action owned by one's debtor by garnisheeing it by notice to the obligor thereof, the rights of the garnisher cannot be greater than those of his debtor, *i. e.,* the obligee of the chose in action. This was very clearly stated in the case just mentioned by Mr. Justice Jackson in 152 U. S. at page 619, 14 S. Ct. 710, 717, 38 L. Ed. 565. After discussing some English cases on the question of the rights secured by such a garnishment and quoting from the remarks of some of the Lord Justices in the case of *In re Combined Weighing & Advertising Machine Company,* 43 Chancery Division, 93, 104, 105, 106 in which the effect of garnishment was under consideration, Mr. Justice Jackson said: 'The proposition here laid down is in harmony with the generally recognized principle that the rights of the garnisher do not rise above, or extend beyond, those of his debtor; that the garnishee shall not, by operation of the proceedings against him, be placed in any worse condition than he would have been in, had the principal debtor's claim been enforced against him directly; that the liability, legal and equitable, of the garnishee to the principal debtor, is a measure of his liability to the attaching creditor, who takes the shoes

of the principal debtor, and can assert only the rights of the latter.'

* * * * * * * *

It would be most unfair that a third person, merely by reason of his interposition, whether he was a soverign or not, should be able to change the rights inter sese between the obligor of the chose in action and his obligee, who is the objective of the levy or attachment."

This same holding appears in *Karno-Smith Company v. Maloney,* Third Circuit, 112 F. (2d) 690, 25 A. F. T. R. 268, an action arising under Section 1114(e) of the Revenue Act, now 3710(a) I. R. C. The Court there held that the rights of the Internal Revenue Collector could rise no higher than those of a taxpayer whose right to property is sought to be levied on under the statute. It held that an insolvent subcontractor had no enforceable right to property in the hands of the general contractor, in view of the contractor's right under New Jersey law to set-off against the balance due the subcontractor, the contractor's obligation, under statutory bond, to the subcontractor's materialman, so as to justify distraint by the Collector of the balance due for the subcontractor's income taxes. The Court pointed out that the right of off-set recognized by New Jersey law was available to the plaintiff, and that by reason of its existence the New Jersey Brick & Supply Co., the insolvent subcontractor, had no enforceable right to property in the plaintiff's hands which was subject to attachment or distraint at the instance of the Supply Company's creditor, the Collector of Internal Revenue. It ac-

cordingly found that the distraints which the latter made were, therefore, not authorized by law and that the sum exacted from the plaintiff was wrongfully collected and should be refunded, stating (p. 692):

> "We think the equities of the case are clearly with the plaintiff. It finds itself in a dilemma forced upon it by law. Under its contract it is obligated to its subcontractor and under its bond it must pay the latter's unpaid debt to its materialman. The two obligations arise out of the same transaction, but payment of the subcontractor's taxes pursuant to the collector's levy and demand will not and cannot discharge the obligation to the subcontractor's materialman which the statutory bond imposes upon the plaintiff. Under these circumstances it would be manifestly inequitable to enforce both obligations. *United States v. Bank of Shelby,* 5 Cir., 68 F. (2d) 538. We think it clear that in a case of this kind the rights of the collector rise no higher than those of the taxpayer whose right to property is sought to be levied on. *United States v. Western Union Telegraph Co.,* 2 Cir., 50 F. (2d) 102."

Even the case of *Commonwealth Bank v. United States,* 6 Cir., 115 F. (2d) 327, 25 A. F. T. R. 982, cited by appellant, holds that a defense exists where there is no property or property rights of the taxpayer in the defendant's possession.

It has been held in California in *John M. C. Marble Co. v. Merchants National Bank of Los Angeles,* 15 Cal. App. 347, 115 Pac. 59, that an attaching creditor merely acquires the rights of the debtor and that a plaintiff in garnishment is in relation to the garnishee substituted merely to the rights of his own debtor, and he may enforce no de-

mand against the garnishee which the debtor in suing could not enforce, the Court stating at p. 350:

> "An attaching creditor is clothed with no greater rights than the debtor himself. He stands in the shoes of the debtor, and any offset which might be urged against the debtor by the garnishee is equally available against the attaching creditor. 'The suing out of a process in garnishment does not in any manner change the rights of the parties to the proceeding further than to transfer the right of the defendant to his creditor to proceed against the garnishee for the collection of the debt due to the principal defendant. It is a rule of universal application that the plaintiff in garnishment is, in his relation to the garnishee, substituted merely to the rights of his own debtor, and can enforce no demand against the garnishee which the debtor himself, if suing, would not be entitled to recover. . . . Another effect of this rule is that the plaintiff is liable to be met by the garnishee on his own behalf with the same set-offs and other defenses that the garnishee might have interposed had an action been brought against him by his own creditor, the principal defendant in the garnishment proceedings.' *Shinn on Attachment*, Sec. 487, *Drake on Attachment*, Sec. 536; *Boles on Modern Law of Banking*, p. 741; *Schuler v. Israel*, 120 U. S. 506, 7 S. Ct. 648, 30 L. Ed. 707."

The Case of *United States v. Long Island Drug Company*, 2nd Ct., 115 F. (2d) 983, has been clarified in part by a later decision, but the following language is still apt:

> ". . . Moreover, there would seem to be no justice in depriving the garnishee of its right to set-off which, so far as the record shows, was acquired for a valuable consideration before the demand was made on the Drug Company by the Collector."

Since the Appellant occupied the position by virtue of its lien of an assignee or of a garnishee, there is no question of Winnett's right to assert his set-offs against the plaintiff. *McKenney v. Ellsworth,* 165 Cal. 326, citing 368 Cal. C. C. P.

This rule is also supported by the following authorities:

United States v. Bank of Shelby, 5th Ct., 68 F. (2d) 538, 13 A. F. T. R. 540. On page 541 it is stated:

> "The general rule in the absence of statute is that to set off an unmatured debt because of insolvency requires the action of equity; *Scott v. Armstrong,* 146 U. S. 499, 36 L. Ed. 1059; *Hecht v. Snook,* 114 Ga. 921, 41 S. E. 74; but that insolvency alone is a sufficient basis in equity for the set-off not only as between the parties but as against a receiver, an assignee for the benefit of creditors, a trustee in bankruptcy, or a garnisher. (Citing *Scott v. Armstrong* and numerous cases.)"

There seems to be no question but that in California all defenses and set-offs against an assignor of a chose in action are available against his assignee. The cases above cited with respect to insolvent creditors bear this out. Another case to the same effect is *Bank of America v. Pacific Ready-Cut Homes,* 122 Cal. App. 154, and in *Wagner v. Central Bank and Securities Company,* 249 Fed. 145, it is stated:

> "All defenses and set-offs available against an assignor of a chose in action are available against his assignee."

Since Winnett's right of set-off existed at the earliest moment that Summers became insolvent, it existed on February 16, 1939. The effect thereof is to limit Summers'

property or rights to property on that date and all subsequent dates to the balance of Winnett's indebtedness after giving effect to the set-offs. With respect to this balance defendant has always conceded that the Appellant's rights are paramount to the rights of all other persons who had no perfected liens at the time.

We have found one case, entitled *In re Dimons Estate,* 32 N. Y. Supp. (2d) 237, wherein the facts are similar to ours and similar questions were raised. Briefly the facts are: Decedent had a checking account at date of death. On that date the depositary was the holder of unsecured notes, one upon demand and one payable at a date subsequent to death. The decedent was indebted to the United States Shipping Board in a large sum. His total unpaid obligations were far in excess of assets. The United States contended it had a preference pursuant to Section 3466, Revised Statutes, over the alleged lien of the bank. The bank refused to pay over, although the administrator had listed the entire checking account as an asset. The court held that the bank's notes came due at decedent's death and that the law of New York gave it the right of set-off. Counsel for the United States Shipping Board conceded that the preferential right did not apply but then contended that the bank was estopped to take the set-off because of crediting interest after the death of decedent. The court held the burden of proof was on the United States to show the bank had knowledge, what date such knowledge was acquired, or that United States had been prejudiced in any way, and on page 244 stated:

> "In the absence of such proof the petitioner as administrator C. T. A. and his predecessor executrix had no greater rights than those conferred by law and commercial usage upon the decedent, *i. e.,* to make due

demand upon the bank for the balance of the checking account, subject, however, to the right of the bank as a creditor to set-off the indebtedness due it upon decedent's notes."

From the foregoing it will be evident that Section 3466, Revised Statutes, has not given appellant a priority which would operate to deprive Winnett of his credits and offsets but that the priority applies to the property of Summers and that this property, as determined by State law (Summers being an insolvent person), was the net balance of $6,466.64. The effect of Section 3466 and this priority is to obviate the necessity of Winnett first paying this sum of $6,466.64 to the administratrix of the Estate of Summers before the appellant would receive it. To recognize any other theory, or the theory of appellant that Section 3466 deprives a debtor of the right of set-off, would render business transactions chaotic. No person could deal with a federal taxpayer without first assuring himself that all federal taxes were constantly paid and that such taxpayer was not then nor later likely to be involved in tax litigation or, failing to do this, be at the mercy of the appellant. Such a theory of business transactions carried to an ultimate conclusion would result in the anomalous situation of two persons running a mutual open and current account, with cross-transactions evidencing merchandise returned perhaps or cash payments made, and if one party became insolvent, the other party would lose all of the credits to which he was entitled because of the governmental priority, and if this were so, even the cash payments would be ignored and the total of all items received from the insolvent be collected without the benefit of offsetting deductions. While this is an exaggerated example, in effect there is no difference from the case at bar. Win-

nett had built up credits under an agreement with Summers against his note just as surely as if he had paid cash or furnished merchandise on account. In all equity and good conscience Mr. Winnett should not be penalized by being required to pay his obligation twice simply because for a period of 11 years appellant slept on its rights and failed to adequately proceed against its taxpayer.

Conclusion.

Since we have demonstrated that the credits and off-sets on the part of Winnett were existing, valid and enforceable as to Summers prior to February 16, 1939, and at all times subsequent thereto, the only property or rights to property of Summers to which the appellant's lien attached on February 16, 1939, was the balance of $6,466.64, and that Section 3466 of the Revised Statutes established no right in appellant which would deprive Winnett of these credits and off-sets, it follows that the judgment should be affirmed.

Los Angeles, California, May 27, 1947.

Respectfully submitted,

MACFARLANE, SCHAEFFER & HAUN and
DEMPSEY, THAYER, DEIBERT & KUMLER,
By RAYMOND V. HAUN,
Attorneys for Appellee.

APPENDIX.

California Code of Civil Procedure:

Section 437. (Contents of Answer: Denials and Statement of New Matter.)

The answer of the defendant shall contain:

1. A general or specific denial of the material allegations of the complaint controverted by the defendant.

2. A statement of any new matter constituting a defense or counterclaim.

Except in justices' courts of Class B, if the complaint be verified, the denial of the allegations controverted must be made positively, or according to the information and belief of the defendant. If the defendant has no information or belief upon the subject sufficient to enable him to answer an allegation of the complaint, he may so state in his answer, and place his denial on that ground. The denials of the allegations controverted may be stated by reference to specific paragraphs or parts of the complaint; or by express admission of certain allegations of the complaint with a general denial of all of the allegations not so admitted; or by denial of certain allegations upon information and belief, or for lack of sufficient information or belief, with a general denial of all allegations not so denied or expressly admitted. If the complaint be not verified, a general denial is sufficient, but only puts in issue the material allegations of the complaint.

Section 438. (When Counterclaim May Be Set Up.)

The counterclaim mentioned in section 437 must tend to diminish or defeat the plaintiff's recovery and must exist in favor of a defendant and against a plaintiff between whom a several judgment might be had in the action; provided, that the right to maintain a counterclaim shall not be affected by the fact that either plaintiff's or defendant's claim is secured by mortgage or otherwise, nor by the fact that the action is brought, or the counterclaim maintained, for foreclosure of such security; and provided further, that the court may, in its discretion, order the counterclaim to be tried separately from the claim of the plaintiff.

Sec. 368. Assignment of Thing in Action Not to Prejudice Defense.

In the case of an assignment of a thing in action, the action by the assignee is without prejudice to any set-off, or other defense existing at the time of, or before, notice of the assignment; but this section does not apply to a negotiable promissory note or bill of exchange, transferred in good faith, and upon good consideration, before maturity.

California Civil Code:

Sec. 3144. When Person Deemed Indorser.

A person placing his signature upon an instrument otherwise than as maker, drawer, or acceptor, is deemed to be an indorser, unless he clearly indicates by appropriate words his intention to be bound in some other capacity.

Sec. 3202. Right of Party Who Discharged Instrument.

Where the instrument is paid by a party secondarily liable thereon, it is not discharged; but the party so paying it is remitted to his former rights as regards all prior parties and he may strike out his own and all subsequent indorsements, and again negotiate the instrument, except—

(1) Where it is payable to the order of a third person, and has been paid by the drawer; and

(2) Where it was made or accepted for accommodation, and has been paid by the party accommodated.